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Dear Director Falcon:

With this letter, FM Watch provides comments on the proposed revision to the OFHEO risk-based capital (RBC) rule published in the *Federal Register* on September 12. [67 FR 57760] FM Watch is an association of major financial services trade associations with deep concern about expansion of the government-sponsored enterprises (GSEs) and the risk this poses to the financial system. Although that notice suggests that this proposed rule is "technical" and that no comments on it are anticipated, FM Watch strongly believes not only that the proposed amendment relating to the calculation of the RBC requirements to account for the affects of FAS 133 is extremely substantive, but also that OFHEO's failure to recognize this points to a major problem in the RBC framework established for Fannie Mae and Freddie Mac.

These GSEs collectively have \$2.83 trillion in outstanding obligations, clearly presenting a major systemic risk. That OFHEO could view as "technical" a rule that would change one GSE's required RBC by 29% argues that it has failed yet to understand that the RBC rule must be a major defense that protects taxpayers and the financial system from GSE risk. We urge OFHEO to defer action on this proposal until a complete review of it demonstrates that the change is not a stopgap concession to a GSE to help it meet the RBC rules that become effective seven days after the end of the comment period. OFHEO must show that this change is consistent first with the treatment of derivatives elsewhere in this complex rule and also that it conforms to Congress' intent to promote safe and sound GSEs. Casual changes based on OFHEO's limited consideration and the markets inability to thoughtfully evaluate the proposal within the inadequate 10 day comment period compound the risks already inherent in the flawed OFHEO capital requirements.

We also urge OFHEO to defer acting on the proposal because rapid action on it may violate Executive Order 93-12866. That Order requires agencies to submit "significant" rulemakings to the Office of Management and Budget (OMB) and to Congress in advance of taking final action on them. In the notice of proposed rulemaking, OFHEO states that it does not believe the Order is applicable because, "...[T]he amendments do not consistently raise or lower capital requirements for the Enterprises." By this reasoning, many rules – even the initial OFHEO risk-based capital one – would not have



been subject to the Executive Order because their impact was not always the same in every single quarter for every year after they were issued.

FM Watch believes that a rule which, on its first hypothetical imposition, affects one GSE by as much as \$1.652 billion meets the "significant" test in EO 93-12866 and therefore must be submitted to OMB. A \$1.652 billion change in a GSE's capital can drive up to \$66 billion in on-balance sheet risk and \$367 billion in off-balance sheet risk (assuming minimum capital requirements). Even if this changes a bit quarter-over-quarter, FM Watch firmly believes the rule's impact clearly is significant and OMB review is therefore mandatory.

### **I. Fundamental Concerns**

FM Watch has long argued that the risk-based capital rules that govern the GSEs must be no less stringent than those that govern insured depositories, and we remain opposed to the overall OFHEO capital rule because it fails this critical test. The results of the test run of the rule released by House Capital Markets Subcommittee Chairman Baker on July 23 indicate that, under one interest-rate scenario, one of the GSEs would have had a risk-based capital requirement under the OFHEO rule with a leverage ratio of 894:1 for on- and off-balance sheet assets. This is a truly astonishing result given their concentration risk in a single asset.

FM Watch also believes that the OFHEO rule must either be consistent with generally-accepted accounting principles (GAAP) or be more stringent than them. Congress has mandated a comparable requirement for bank regulators in 12 USC 1831n(a)(2). It similarly did so for the Federal Housing Finance Board for the Home Loan Bank capital standards in 12 USC 1426(a)(5) OFHEO is required pursuant to 12 USC 4502(4) to ensure that its definitions of the components of core capital meet GAAP, and we must therefore conclude that the lack of clarity over whether GAAP must also apply to the RBC rules results from OFHEO's failure to interpret its mandate correctly, not from Congress' decision to allow OFHEO – in sharp contrast to the bank regulators and the FHFB – to pick and choose among those sections of GAAP that may meet its or a GSE's needs at any one point in time. The vital role the GSEs play in both the mortgage market and the overall economy requires that OFHEO use caution when calculating their RBC or when prescribing accounting standards to be used in its determination. In comments made August 4, 2002, Federal Reserve Bank of St. Louis President William Poole noted the critical importance of GSE capital and its disturbing variance from bank capital. FM Watch questions why OFHEO proposes to further widen the differences between its approach to RBC and that of the Federal Reserve Board.



## II. Specific Comments

### A. Does OFHEO Really Know The Impact Of This Rule?

FM Watch would note that OFHEO's statement on the impact of this proposal has varied materially in the three-day period between which a version of the rule, represented as a final one, was posted on the OFHEO website on September 9 and a significantly revised version was forwarded to the Federal Register on September 12. On September 9, OFHEO represented that the proposed change would drop Freddie Mac's surplus (based on first-quarter, 2002 data) by \$2 billion; by Wednesday, this number was \$1.652 billion – a \$348 million difference. Fannie Mae's capital changed even more dramatically – going from a drop in required capital of \$300 million to an increase of \$121 million.

Given this significant variation in OFHEO's impact calculation in the space of three days, one has to wonder if the data released in the Wednesday version of the rule are in fact a final and correct estimate of its impact. Further, we would note that markets have changed dramatically since the first-quarter data on which these estimates were based. Fannie Mae, for example, has announced sharp increases in its interest-rate risk (duration gap) in July, which was exacerbated in August. If the impact of the proposed change were run today it could have a far more substantial effect on that GSE's risk-based capital. OFHEO should take no action without providing firm and current data on the implications of the proposed revision, including an understanding of how this change may incent the GSEs to use derivatives.

### B. Proposed Change is Substantive as Prior Comments Demonstrate

FM Watch disputes OFHEO's suggestion that this rule is a minor "technical" change in line with the other punctuation and similar truly technical revisions in the proposal. To support this contention, we would remind OFHEO of the detailed discussion of the treatment of FAS 133 included in the comment letter filed by Fannie Mae with the Office in March 2001. In its September 2001 final rule, OFHEO carefully considered the FAS 133 issue at length, appropriate in light of the substantive nature of the change, and chose the path set forth in its final rule. [66 FR 47786] Thus, it is hard to understand how OFHEO could now deem as "technical," adjusting required RBC by adding back in the effects of FAS 133.

OFHEO also describes this change as one that belatedly brings the RBC rule into conformity with a provision in the 1992 Act that has not changed in the intervening decade. We remain perplexed as to why OFHEO did not simply do so in its first version of the rule or quickly adopt the Fannie Mae suggestion to do so if the change is in fact so straightforward.

### C. Correct Accounting for Derivatives Use Essential

Appropriate accounting for GSE derivatives in relation to the RBC rule is essential because of the favorable haircut treatment OFHEO has given derivatives to offset tangible equity and other capital resources. It is our understanding that the GSEs will provide OFHEO with two sets of numbers in running the stress test. First, they will run it on their books, which are properly kept in accordance with GAAP and thus comply with FAS 133. They will then, however, provide another set of numbers which reverse FAS 133 valuation changes, determining RBC from these data. Apparently, the new proposed change will "add back in the effects of the FAS 133." OFHEO has chosen this cumbersome approach because, as noted in the proposal, it believes the stress test is too "stylized" to permit complete application of FAS 133. We are completely at a loss on what OFHEO means here. The GSEs will be supplying FAS 133 data, and it remains unclear why this proposed regulatory adjustment is warranted to make the OFHEO rule work.

Although some continue to question how well FAS 133 may work, it is the best standard the Financial Accounting Standards Board was able to construct and is the one to which all other firms, including insured depositories, must comply in meeting their regulatory capital standards. It is also the data on which investors depend, and it will be difficult for them to determine any underlying problems in the GSEs' risk profile since the RBC rule may not fully utilize this generally available and widely-accepted information. This undermines the goal of improved transparency, so recently reinforced by Treasury Undersecretary Peter Fisher in his statements on GSE investor-related disclosures. Rewriting GAAP for GSE RBC purposes will inhibit market discipline, which the Basel committee has rightly decreed to be the third pillar on which effective supervision of financial institutions must rest.

### D. Rule May Not Comply with Law

Finally, we are confused by the proposal to apply the adjustment to GSE capital after all of the other factors necessary to determine the rule have been calculated. Indeed, we would note that the proposal adds a new ninth line to the RBC calculation after the hundreds of pages used to reach the other eight lines in the final calculation. One would have assumed that a "technical" change would not be so fundamental a revision to the final equation used to calculate capital compliance. However, we also note that the proposal requires the GSEs to add the 30% operational/management risk add-on only to the first eight lines in the capital calculation, not to the adjustment made in the new ninth one. We question this, since we read the 1992 Act as requiring the 30% add-on to the final determination of credit and interest-rate risk-based capital, and we do not believe Congress gave OFHEO authority to adjust the capital requirement any further thereafter 12 U.S.C. 4611(c)(2).



### III. Conclusion

In light of the foregoing, FM Watch urges OFHEO to defer action on this proposal until a sufficient comment period has elapsed and all views can be carefully considered. Failure to do so could expose OFHEO to a violation of Executive Order 93-12866. Even more important, the proposed changes could heighten the systemic risk already presented by Fannie Mae and Freddie Mac. No safety-and-soundness regulator should move on a change as profound as this proposal without full and careful consideration.

We would be pleased to provide any assistance OFHEO needs as it takes additional action on this issue.

Sincerely,

A handwritten signature in black ink, appearing to read 'W. Michael House'.

W. Michael House  
Executive Director

cc.

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